UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
SOUTH BEND DIVISION

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| IN THE MATTER OF | ) | |
| | ) | |
| SANDRA M. HATTON, | ) | CASE NO. 03-36781 HCD |
| fka SANDRA GRABER, | ) | CHAPTER 7 |
| | ) | |
| DEBTOR. | ) | |

Appearances:

William L. Hoehner, Esq., attorney for debtor, Hoehner & Associates, P.C., 330 South 35th Street, South Bend Indiana, 46615;

Jennifer W. Prokop, Esq., attorney for debtor, Hoehner & Associates, P.C., 330 South 35th Street, South Bend, Indiana 46615;

Gary D. Boyn, Esq., Trustee, Warrick & Boyn, LLP, 121 West Franklin Street, Suite 400, Elkhart, Indiana 46516; and

William Law, Esq., attorney for trustee, Warrick & Boyn, LLP, 121 West Franklin Street, Suite 400, Elkhart, Indiana 46516.

MEMORANDUM OF DECISION

At South Bend, Indiana, on May 5, 2004.

Before the court is the Trustee's Objection to Allowance of Claimed Exemption, filed on January 2, 2004, by Gary D. Boyn, Esq., the duly appointed chapter 7 Trustee in this case. The Trustee has objected to the exemption claimed by the debtor, Sandra M. Hatton, in a 401(k) retirement plan established by her deceased husband. At the hearing on the objection, held on February 2, 2004, the parties agreed that the issue was the legal interpretation of the Indiana exemption statute, Indiana Code § 34-55-10-2(b)(6). On March 18, 2004, after each party filed briefs on the issue, the matter was taken under advisement. For the reasons that follow, the court overrules the Trustee's objection to the allowance of the exemption as moot.

## Jurisdiction

Pursuant to 28 U.S.C. § 157(a) and Northern District of Indiana Local Rule 200.1, the United States District Court for the Northern District of Indiana has referred this case to this court for hearing and determination. After reviewing the record, the court determines that the matter before it is a core proceeding within the meaning of § 157(b)(2)(B) over which the court has jurisdiction pursuant to 28 U.S.C. §§ 157(b)(1) and 1334. This entry shall serve as findings of fact and conclusions of law as required by Federal Rule of Civil Procedure 52, made applicable in this proceeding by Federal Rule of Bankruptcy Procedure 7052. Any conclusion of law more properly classified as a factual finding shall be deemed a fact, and any finding of fact more properly classified as a legal conclusion shall be deemed a conclusion of law.

## Background

The facts are not in dispute. The debtor, Sandra M. Hatton, was married to Samuel Graber from 1994 until he passed away on March 5, 2000. Graber worked for Federal Mogul making pistons. He established a 401(k) retirement plan and designated his wife Sandra as the beneficiary. Graber contributed to the plan and his employer appropriately matched the contributions. The plan qualified as a 401(k) and was not subject to federal income taxation. Soon after Graber died, his 401(k) retirement account was closed and the funds in it were placed into a new 401(k) account in the name of Sandra Graber. She later changed her name to "Hatton."

The debtor filed her voluntary chapter 7 bankruptcy petition on November 26, 2003. On Schedule C of her bankruptcy petition, the debtor claimed an exemption of her interest in the 401(k) plan set up by her deceased husband's employer, in the amount of $11,358.00. She stated on Schedule C that the exemption was provided under Indiana Code § 34-55-10-2(b)(6), which exempts:

(6) an interest, whether vested or not, that the judgment debtor has in a retirement plan to the extent of:

(A) contributions, or portions of contributions, that were made to the retirement plan:

(i) by or on behalf of the debtor; and

(ii) which were not subject to federal income taxation to the debtor at the time of the contribution;

(B) earnings on contributions made under clause (A) that are not subject to federal income taxation at the time of judgment; and

(C) roll-overs of contributions made under clause (A) that are not subject to federal income taxation at the time of the judgment.

Ind. Code § 34-55-10-2(b)(6).

The Trustee objected that the debtor's interest in the retirement plan did not qualify for exemption on the ground that the plan funds were not deposited by the debtor or by a third party for her benefit. The Trustee explained that retirement plan assets are exempt only if the contributions to the plan were made either by the debtor or on behalf of the debtor. In this case, he pointed out, the contributions were made by the debtor's husband (the employee) and by his employer on the employee husband's behalf. Therefore, the Trustee insisted, the 401(k) plan could not be exempted from the debtor's bankruptcy estate.

The Trustee also noted that the previous Indiana exemptions statute (held unconstitutional under *In re Zumbrun*, 626 N.E.2d 452 (Ind. 1993)) included all retirement plans in which a debtor had an interest. The Indiana Supreme Court revisited *Zumbrun* after the statute was amended and found that the amended provisions placed a reasonable limit on the exemptions and thus were not constitutionally suspect. *See Citizens Nat'l Bank of Evansville v. Foster*, 668 N.E.2d 1236, 1242 (Ind. 1996). However, the Trustee contended that, "because anyone may be named a plan beneficiary, the amount of funds which could be exempted under a beneficiary-based approach is limitless," and for that reason the state statute would be "constitutionally suspect." R. 24 at 6. The Trustee therefore asked the court to disallow the exemption and to determine that the entire value of the debtor's husband's 401(k) plan be included in the bankruptcy estate.

The debtor responded that she was entitled to an exemption in her interest in her deceased husband's 401(k) plan under the state statute. According to the debtor, the plan was properly established by

her husband and qualifies as a retirement plan under 26 U.S.C. § 401(k). She, as his spouse and as the designated beneficiary, received the distribution of the funds upon his death in the form of a 401(k) plan established in her married name, "Sandra Graber." The debtor asserted that the funds in Sandra Graber's 401(k) plan were placed there "on her behalf" and belonged to her, not to her deceased husband. They were not subject to any federal income taxation at the time they were placed in the plan and are not subject to taxation at this time. Therefore, she contended, her 401(k) satisfied the requirements of Indiana Code § 34-55-10-2(b)(6) and entitled her to exempt her interest in the plan from inclusion in her bankruptcy estate.

Discussion

The issue presented to the court is whether the debtor's claimed exemption should be disallowed. At the hearing, the parties agreed that no facts were in dispute and that the issue was a legal one: whether the term "by or on behalf of the debtor," found in Indiana Code § 34-55-10-2(b)(6), encompasses the surviving spouse as the debtor. The Trustee, as the party objecting to the exemption, has the burden of proving that the exemption was not properly claimed. *See* Fed. R. Bankr. P. 4003(c); *In re Cross*, 255 B.R. 25, 30 (N.D. Ind. 2000).

Section 522 of the Bankruptcy Code allows a debtor to exempt certain property from the bankruptcy estate and to place it beyond the reach of creditors. *See* 11 U.S.C. § 522(b). Exemption statutes should be liberally construed in favor of debtors to allow each exemption to protect the debtor and the debtor's family. *See In re Zumbrun*, 626 N.E.2d at 455; *South Bend Community School Corp. v. Eggleston*, 215 B.R. 1012, 1015 (N.D. Ind. 1997). Indiana is a state that has chosen to opt out of the federal bankruptcy exemptions and to substitute its own system. S*ee In re Oakley*, 344 F.3d 709, 710 (7th Cir. 2003); *In re Burns*, 218 B.R. 897, 898 (Bankr. N.D. Ind. 1998). The state has provided a list of the property available for exemptions under Indiana Code § 34-55-10-1 and a list of the amount of each exemption under Indiana Code § 34-55-10-2. The state exemption for retirement plans, found at § 34-55-10-2(b)(6), was amended

to allow an exemption to the extent of the contributions made to a plan by or on behalf of the debtor that were not subject to federal income taxation to the debtor at the time of the contribution. The Supreme Court of Indiana had "announced a bright-line rule in *Zumbrun*, that a statute lacking a limit on the exemptible amount is unconstitutional on its face," *see Foster*, 668 N.E.2d at 1242, but found the amended exemption statute, requiring that the contributions not be subject to federal income tax, to be constitutional:

> [W]e accord a high degree of deference both to the legislature's identification of various types of property debtors may keep despite their failure to pay their debts, and to the limits the legislature selects within each type of property. So long as the legislature articulates some limitation, it is the burden of the party seeking to invalidate the statutory exemption to demonstrate that the limitation does not go far enough for constitutional purposes.

*Id*. at 1241. Under Indiana's exemption statute, therefore, the state supreme court found that Individual Retirement Accounts ("IRAs") that are limited to the amounts not subject to federal income taxation might be exempted from creditors' claims. *See id.; see also Moncel v. Chosnek (In re Moncel)*, __ B.R. __, 2004 WL 396126 at *3 (N.D. Ind. 2004) (concluding that "Indiana law exempts contributions to retirement plans only if they were not subject to federal income taxation at the time they were made," and thus that a debtor's contribution to a Roth IRA, which was subject to federal income taxation, is not exempt). Because the debtor's 401(k) retirement plan was not subject to federal income taxation, either when Samuel Graber established it or when it was transferred to Sandra Graber's account, the court finds that it would fall within the parameters of the Indiana exemption law.

Nevertheless, the court is of the view that the parties raised the exemption issue precipitously, prior to asking whether the debtor's interest in the 401(k) plan is property of the bankruptcy estate. Before the court determines whether the debtor's 401(k) plan qualifies for an exemption, it first must decide whether it is property of the estate under § 541. *See* § 522(b) (permitting debtor to exempt property from property of the estate "[n]otwithstanding section 541"); *see also In re Domina*, 274 B.R. 829, 833 (Bankr. N.D. Iowa

2002) (reviewing debtor's claim of exemption in a deferred compensation plan, finding that debtor's interest in plan was not property of estate, declining to rule on exemption issue).

> Whether Debtor's plans are excluded from the estate is a question that should be addressed by the bankruptcy court in the first instance. The exemption question arises only if the plans are first determined to be property of the estate. In fact, if the plans are not property of the estate, the bankruptcy court should not make a decision on the exemption question.

*Spirtos v. Moreno (In re Spirtos)*, 992 F.2d 1004, 1007 (9th Cir. 1993).

A bankruptcy estate is broadly comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a). However, certain interests of a debtor are explicitly excluded from the estate. One such exclusion is found in § 541(c)(2):

> A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under [the Bankruptcy Code].

11 U.S.C. § 541(c)(2). The Supreme Court held that a provision that forbids the assignment or alienation of pension plan benefits is required under the nonbankruptcy Employee Retirement Income Security Act of 1974 ("ERISA"), and it constitutes an enforceable transfer restriction in bankruptcy for purposes of § 541(c)(2). *See Patterson v. Shumate*, 504 U.S. 753, 765, 112 S. Ct. 2242, 2250, 119 L.Ed.2d 519 (1992) (holding that "a debtor's interest in an ERISA-qualified pension plan may be excluded from the property of the bankruptcy estate pursuant to § 541(c)(2)"). ERISA imposes restrictions on the transfer of a debtor's interest in a qualified plan, and these restrictions are enforceable, as § 541(c)(2) requires. As the Supreme Court explained in *Patterson*, "our decision today ensures that the treatment of pension benefits will not vary based on the beneficiary's bankruptcy status." *Id.* at 764, 112 S.Ct. at 2249.

In determining whether the debtor's interest in the 401(k) plan may be excluded or exempted from the bankruptcy estate, therefore, the inquiry first focuses on whether the plan is ERISA-qualified. If it is an ERISA-qualified plan, then a debtor's interest in it is excluded from property of the estate altogether under *Patterson*. If it is a non-ERISA retirement plan, however, it may qualify for exemption under the terms

of the statutory state exemption, Ind. Code § 34-55-10-2(b)(6).[1] "Thus, the only inquiry is whether the Plan . . . [was] ERISA-qualified." *In re Baker*, 195 B.R. 386, 391 (Bankr. N.D. Ill. 1996), *aff'd*, 114 F.3d 636 (7th Cir. 1997). The term "ERISA-qualified" is not defined in *Patterson* or in the Bankruptcy Code, "and its provenance is mysterious." *In re Baker*, 114 F.3d 636, 638 (7th Cir. 1997) (suggesting that "the Court used 'ERISA-qualified' to mean 'covered by Subchapter I of ERISA'"). In this circuit, an "ERISA-qualified" plan is one governed by ERISA and containing the anti-alienation clause required by § 206(d)(1) of ERISA.[2] *See id.; see also In re Hanes*, 162 B.R. 733, 739 (Bankr. E.D. Va. 1994).

A plan established under § 401(k) of the Internal Revenue Code is one type that is subject to ERISA. *See In re Lucas*, 924 F.2d 597, 598 (6th Cir.), *cert. denied*, 500 U.S. 959 (1991) (analyzing § 401(k) plan, holding that debtor's interests in ERISA-qualified plan are not property of debtor's bankruptcy estate and are not subject to turnover to trustee). It contains an anti-alienation provision and restricts the employee's use of the funds. In this case, the debtor's husband was eligible to participate and did contribute to his employer's plan. Based on the undisputed evidence in this case, the court finds that the 401(k) plan established by Samuel Graber was an ERISA-qualified retirement plan that would qualify for exclusion from property of a bankruptcy estate under § 541(c)(2). There seems to be no doubt that, if Samuel Graber were the debtor in this case, rather than his widow, he properly could have claimed that his interest in the 401(k) plan was excluded from the bankruptcy estate. *See In re Dunn*, 988 F.2d 45 (7th Cir. 1993) (per curiam)

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[1] *Patterson* made clear that the federal exemption statute, § 522(d)(10)(E), "exempts from the bankruptcy estate a much broader category of interests than § 541(c)(2) excludes." *See Patterson*, 504 U.S. at 762, 112 S. Ct. at 2249.

[2] Other courts have found that a pension plan is ERISA-qualified for purposes of § 541(c)(2) if it is tax-qualified under 26 U.S.C. § 401(k), is subject to ERISA, and includes an anti-alienation provision. *See In re Harris*, 188 B.R. 444, 449 (Bankr. M.D. Fla. 1995); *Gilbert v. Foy (In re Foy)*, 164 B.R. 595, 597 (Bankr. S.D. Ohio 1994); *In re Hall*, 151 B.R. 412, 419 (Bankr. W.D. Mich 1993). The Third Circuit has set forth a five-prong test. *See Orr v. Yuhas (In re Yuhas)*, 104 F.3d 612, 614 (3d Cir.), *cert. denied*, 521 U.S. 1105 (1997).

(holding that debtor's contributions to ERISA-qualified 401(k) plan were excluded from bankruptcy estate); *cf*. *In re Sims*, 241 B.R. 467, 469 (Bankr. N.D. Okla. 1989) (finding that father's IRA would have qualified for exemption but that son's inherited IRA account could not be claimed as exempt). The question is whether the existing 401(k) qualifies for exclusion from the estate of this debtor, Samuel Graber's surviving spouse and the beneficiary of the 401(k) plan he established.

The Trustee has not challenged the contents of the 401(k) plan itself or the circumstances surrounding its creation by Samuel Graber and its transfer to a new account in the name of Sandra Graber. Instead, he offers two reasons for asserting that the 401(k) fund created by the debtor's husband could not qualify for an exemption when it was transferred to his wife, the debtor: (1) The contributions were not made by the debtor or on her behalf; and (2) anyone could be named as a beneficiary and, because the pool of beneficiaries of a 401(k) thus is unlimited, the exemption statute is rendered constitutionally suspect. The court considers whether these are valid reasons to deny the exclusion, rather than exemption, of the debtor's interest in the 401(k) plan.

In this case, the 401(k) assets in Samuel Graber's retirement account were not withdrawn, liquidated, or actually distributed; had they been, that amount would have been taxable to the distributee. *See* 26 U.S.C. § 402(a). Instead, the qualified trust assets were rolled over into an account created for the benefit of the wife of the deceased who was named as the beneficiary. The Internal Revenue Code protects this "rollover" distribution into another 401(k) and treats it as excludable from income. It provides:

> § 402(c)(9): Rollover where spouse receives distribution after death of employee. —
>
> If any distribution attributable to an employee is paid to the spouse of the employee after the employee's death, the preceding provisions of this subsection [i.e., deferred taxation] shall apply to such distribution in the same manner as if the spouse were the employee.

26 U.S.C. § 402(c)(9). This section therefore permits the rollover of a 401(k) plan distribution to a surviving spouse after the death of the employee and treats the spouse's 401(k) as likewise exempt property.[3] Because in this case the deceased husband's 401(k) was distributed by rollover to the debtor, the court finds that it qualifies for exclusion from the property of the bankruptcy estate pursuant to § 541(c)(2).

The court also finds that, in circumstances such as the one before the court, not any person named as a beneficiary would be entitled to an exemption on the retirement account. The regulations state that the rollover treatment is limited to the surviving spouse as a beneficiary. *See* § 1.402(c)-2, Q & A 12(b), Income Tax Regs. (cited in *Timmerman v. CIR*, T.C. Summ. Opp. 2002-51, 2002 WL 1816080 (U.S. Tax Ct. 2002) (nonprecedential opinion). When the recipient or distributee is not the employee's spouse, the distributed retirement plan assets are treated as a lump sum distribution that is taxable and therefore cannot be excluded under § 541(c)(2). *Cf. In re Sims*, 241 B.R. at 469 (finding that son's inherited IRA account could not be claimed as exempt).

The court finds, therefore, that the debtor's 401(k) plan is an ERISA-qualified plan. It further determines that the debtor's interest in the plan is not included in the bankruptcy estate under § 541(c)(2). Thus it does not require an exemption from the bankruptcy estate. As property excluded from the estate, it is excluded from the bankruptcy administration and from the distribution to creditors. The court having determined the issues pursuant to § 541(c)(2), it finds that the debtor's claimed exemption was unnecessary and the Trustee's objection to the exemption is overruled as moot. *See In re Domina*, 274 B.R. at 833; *In re Holst*, 192 B.R. 194, 200 (Bankr. N.D. Iowa), *aff'd*, 197 B.R. 856 (N.D. Iowa 1996).

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Some rollovers of contributions can create tax consequences and can cause an exempt retirement plan to become nonexempt. *See, e.g., Moncel v. Chosnek (In re Moncel)*, __ B.R. __, 2004 WL 396126 at *3 (N.D. Ind. 2004) (finding that the debtor's traditional IRA account, which may have been exempt under the statute because it was not subject to federal tax when made, was rolled over to a Roth IRA account and was subject to income taxation in the debtor's tax return, and therefore was not exempt). *See* 2004 WL 396126 at *2.

Conclusion

For the reasons stated above, the court finds that the debtor's interest in the 401(k) plan qualifies for exclusion from the bankruptcy estate under 11 U.S.C. § 541(c)(2). It further finds that this court is without subject matter jurisdiction over it, for it is outside the bankruptcy estate. Accordingly, the Trustee's objection is overruled as moot.

SO ORDERED.

JSO1

HARRY C. DEES, JR., CHIEF JUDGE
UNITED STATES BANKRUPTCY COURT